P 100721Z NOV 08
FM AMEMBASSY ABU DHABI
TO SECSTATE WASHDC PRIORITY 1736
DEPT OF TREASURY WASHINGTON DC PRIORITY
INFO GULF COOPERATION COUNCIL COLLECTIVE
AMEMBASSY TOKYO
AMCONSUL DUBAI
NSA WASHINGTON DC
NSC WASHDC
CIA WASHDC

S E C R E T ABU DHABI 001287

TREASURY FOR D/S KIMMITT, U/S LEVEY, U/S MCCORMICK
NSC FOR DPRICE
STATE FOR EB

E.O. 12958: DNG: CO 11/10/2032
TAGS: AE ECON IR
SUBJECT: UAE VIEWS ON GLOBAL FINANCIAL TURMOIL

Classified By: Ambassador Olson for reasons 1.4 b and d.

¶1. (C) Summary. On 27 and 28 October 2008, Treasury Deputy Secretary Kimmitt and Ambassador Olson met with officials from the UAE Central Bank, UAE Ministry of Finance and Abu Dhabi sovereign wealth funds. Kimmitt discussed the USG response to the global financial turmoil and prospects for the U.S. economy, solicited input on the regional implications, stressed U.S. commitment to open investment principles, encouraged continued vigilence with respect to Iran, and assured that transition planning was underway at the Treasury Department to ensure a smooth handoff to the next administration. End Summary.

Lehman Collapse Rattles Abu Dhabi

¶2. (C) D/S KIMMITT DESCRIBED U.S. STEPS TO PRESERVE STABILITY IN THE FINANCIAL SECTOR. ABU DHABI INVESTMENT COUNCIL (ADIC) OFFICIALS QUESTIONED KIMMITT ABOUT THE USG DECISION TO ALLOW THE FAILURE OF U.S. INVESTMENT BANK LEHMAN BROTHERS. ADIC MANAGING DIRECTOR KHALIFA AL KINDI REPEATED SPECULATION THAT LEHMAN'S COLLAPSE WAS PART OF A DEAL WITH THE U.S. CONGRESS, PAVING THE WAY FOR THE $770 BILLION EESA PACKAGE. KIMMITT EXPLAINED THAT THERE WAS NO BUYER FOR LEHMAN AS THERE WAS FOR BEAR STEARNS, AND THAT AT THE TIME TREASURY LACKED THE AUTHORITY TO INJECT CAPITAL OR TAKE OTHER STEPS. (COMMENT: ADIC'S DIRECT AND SUSTAINED QUESTIONING ON THE LEHMAN BROTHER'S COLLAPSE SUGGESTS THAT THE SWF LIKELY SUSTAINED LOSSES FROM HOLDING LEHMAN DEBT INSTRUMENTS. END NOTE.)

¶3. (C) ADIC OFFICIALS QUESTIONED KIMMITT ON THE SECURITIZATION PROCESS AND HOW IT SHOULD BE CHANGED, SPECIFICALLY TO CONFRONT THE CONFLICT OF INTERESTS RESIDING AT THE CREDIT RATING AGENCIES. KIMMITT STRESSED THE NEED TO REACT, BUT NOT OVERREACT, POINTING TO THE IMPLEMENTATION OF SARBANES-OXLEY AS AN EXAMPLE OF AN OVERREACTION. ADIC OFFICIALS ASKED IF WE COULD EXPECT NEW REGULATION COVERING AREAS SUCH AS HEDGE FUNDS, SHORT SELLING AND COUNTERPARTY RISK. ADIC STATED THAT IN GENERAL, HEDGE FUNDS ARE DOWN 30-50% ON THE YEAR, THAT MANY CANNOT SURVIVE, AND THERE WILL BE RIPPLE EFFECTS AS THEY COLLAPSE.

¶4. (C) ADIA chief investment strategist Jean-Paul Villian stated that the U.S. financial system appears poised to move out of the crisis phase and markets are beginning to refunction., He believes massive fiscal stimulus programs are needed to re-inflate the economy, matching the steps taken to support the financial sector. he noted that the normal cycle is starting to take place, with savings up and inflation down. Villian believes the key to a strong recovery lies with U.S. consumer confidence.

Picture of a Bailout

¶5. (C) ADIC MD Al Kindi and UAE Central Bank Governor Sultan

al Suwaidi described the effects of the credit and equity market turmoil on UAE finances. They pointed to a number of events challenging UAE's banking sector, including, the freezing of international credit markets, substantial outflows of foreign capital speculating on a dirham revaluation (approximately 150 billion dirham), aggressive local lending for the last several years resulting in loans outpacing deposits by 15%, and some CDO exposure. As a result, local banks put 'full brakes' on lending. Where the UAE economy grew at 15% last year, Al Kindi expects it will slow to 4-5% growth next year. According to Al Kindi, deleveraging in Dubai is occurring, debt instruments will come due, banks won,t lend, and Dubai will sell assets. Inflation will drop from 15% to 5%. (Note: $1 buys 3.67 UAE dirham. End Note.)

¶6. (S) In order to support the UAE economy and financial system, all liquid instruments from ADIC will be injected into local banks, according to Al Kindi. he estimated that over the next 12 months, UAE banks will need 80 billion dirham to cover the 4-5% GDP growth, and the government will need to inject a total of 200 billion dirham into the financial sector. (Note:This figure includes already announced injections and liquidity measures totaling 70 billion dirham. End note.) as a result, Al Kindi anticipates that the UAE must come up with approx. 150 billion dirham for the next twelve months, assuming current conditions hold. (Note: ADIC owns majority stakes in Abu Dhabi's two largest banks and is the primary Abu Dhabi SWF charged with backing the growth of Abu Dhabi's economy. End note.)

¶7. (C) Contrasting with Al Kindi,s admissions, UAE Central Bank Governor al Suwaidi separately stated that deposits from Abu Dhabi SWFs into UAE banks had not come in a significant way, and will not be needed. He said that when interbank lending returns, normalcy should return., (Note: ADIC MD Al Kindi is known for providing blunt and accurate assessments to USG officials, while the Central Bank Governor has been a more elusive interlocutor. End note.) The Governor said the UAE banking system stands at 1.4 trillion dirham, or slightly over two times UAE GDP.

¶8. (S) If Abu Dhabi decides to place a floor under the falling UAE equity markets, ADIA and the Abu Dhabi Department of Finance will be called upon, according to Al Kindi. During a meeting with ADIA officials, UAE Central Bank chairman Khalil Foulathi asked for Treasury views on emerging market governments acting to support local equity markets, citing Hong Kong's 1998 intervention. (Note: such questioning seems to indicate that the UAEG is considering some form of intervention in the UAE equity markets, which have plummeted in the last two quarters. End note.)

¶9. (S) Al Kindi warned that the UAE federal guarantee of bank deposits did not stem the flight to safety within the UAE banking system, i.e. depositors are moving accounts from UAE banks perceived as weaker to those perceived to have stronger balance sheets. He said that banks will be merged and recapitalized. He noted that ADIC was buying National Bank of Abu Dhabi and Abu Dhabi Commercial Bank debt instruments trading at a 12-18% annualized return, as a default on the this paper is tantamount to an Abu Dhabi default.

¶10. (C) Addressing the Central Bank's attempts to increase liquidity, Foulathi admitted that the UAE Central Bank has never had discount window operations before. Setting up this function both at the Central Bank and within the commercial banks is taking time, causing under utilization of the liquidity facilities. Central Bank Governor al Suwaidi quantified utilization of Central Bank lending facilities at 15% of available amounts, which in his view demonstrates that the balance sheets and liquidity positions of local banks are stronger than expected. (Note: Governor al Suwaidi can be less forthcoming than some of his peers when sharing problems in the UAE banking sector. End note.)

Pressures in the Interbank Lending Market

¶11. (C) Regarding the debt obligations of UAE banks, Central Bank Governor al Suwaidi stated that local banks had some exposure to medium-term notes and Euro Commercial Paper (9.9% of total assets); however, maturities had not come in yet. Al Suwaidi noted that interbank lending amounted to 12.7% of total assets, most of which is UAE interbank. Foulathi and al Suwaidi agreed that liquidity measures and government guarantees has eased the pressure from three weeks ago.

¶12. (C) Governor al Suwaidi pointed out that other GCC countries announced similar liquidity and confidence measures, however, UAE,s banking sector was far more exposed to the international financial system. For example, he noted that the UAE receives 50% of all GCC SWIFT messages.

¶13. (C) The Governor advocated greater cooperation among GCC states to dampen the impact of the crisis. in particular, he pressed the need for the GCC to announce a GCC guarantee on all GCC interbank lending, as the interbank market in the UAE and between the UAE and foreign banks was not functioning., He advised that the GCC countries were split over this issue, with some members afraid that such a move would signal a bigger problem to already nervous investors.

Necessary Rebalancing in Sight

¶14. (C) UAE Central Bank Chairman Khalil Foulathi explained that risk taking in the UAE increased as oil prices rose, resulting in greater lending in the commercial and retail sectors. Bank lending went from 300 billion dirham in 2004 to 900 billion dirham in current year. During the currency speculation period, Foulathi explained, the Central Bank tried to sterilize the massive increase in the money supply, but banks got excited and over lent as if the hot money deposits were a stable base to lend against. He likened the situation to a 'dream' and a 'party;' the banks got caught when the currency uncertainty dissolved, credit markets froze and oil prices dropped.

¶15. (C) Looking down the road, Foulathi noted the positive outcome of the crisis in that a healthy dose of reality will be served into real estate growth and prices. During the correction, the government may need to support some firms in the real estate sector in order to manage confidence and ensure an orderly transition.

¶16. (C) Commenting on the real estate market in the UAE, Central Bank Governor al Suwaidi suggested that according to economic data, the UAE needs more hotel rooms and hotel apartments, as high prices were discouraging foreign tourists. hHe offered that some developments intended for other purposes may reposition into this market. In the leased apartment and office market, he speculated that most buildings are controlled by single owners with deep pockets who will not have to sell at low prices. As such, the Governor does not expect a disorderly correction in the UAE real estate market.

¶17. (C) The Central Bank Governor expected inflation to be reduced dramatically, likely coming in under 10% for 2008 annualized. He pointed to anecdotal data that steel and cement prices were off 50% from their recent highs. UAE Ministry of Finance Under Secretary Younis al Khoori advised that the UAE was in the process of reformatting its consumer price index. He expressed appreciation for the support received from the U.S. Treasury Department,s Office of Technical Assistance, which is currently evaluating UAE,s request for assistance in standing up a fiscal policy unit.

A New Day for Central Bank Oversight?

¶18. (C) ADIC MD Al Kindi stressed that the financial sector needs better oversight by the Central Bank to prevent excessive risk taking. He complained that local banks do not respect the Central Bank and advised that a new board was put

in place that will strengthen the institution,s regulatory and oversight functions.

¶19. (C) Acknowledging criticism of poor regulatory oversight by the Central Bank, Governor al Suwaidi informed that the regulator is gearing up for thorough revision., He said that the UAEG is planning to be very harsh in its review of bank balance sheet and lending practices. He admitted that real estate is a significant portion of bank exposure and an important source of doubt internally and externally. The Governor stated that the they would publish all numbers and be transparent,, a process he anticipated would be painful.,

¶20. (C) The Governor said that going forward, UAE banks will only be allowed to grow as deposits grow. If they are overleveraged, they must shrink their leverage first.

¶21. (C) The Governor announced that a decision has been made at the federal level, but not implemented, to integrate banking and insurance regulation under the Central Bank. This move will leave only capital markets outside of Central Bank regulatory authority, and better position the UAE to move ultimately to a single regulator.

Praise for SWF Initiative

¶22. (C) ADIA board member and Abu Dhabi Executive Council member Hamad al Hurr al Suweidi praised the collaborative work of ADIA, GIC and U.S. Treasury on SWF best practices, and expressed satisfaction with the Santiago principles. He thanked Treasury for its support and noted Kimmitt,s January 2008 Foreign Affairs article that served to anchor and frame the public debate. Hamad described ADIA,s outreach efforts to introduce ADIA to recipient countries, including visits to UK, France, Germany, Japan, Australia and other nations. He noted that ADIA has always advocated the U.S. approach to foreign direct investment, and has encouraged other countries to emulate the U.S. CFIUS process, which keeps the U.S. open to foreign investment and only reviews cases with national security concerns.

OLSON